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European Private Loans Benefit from Credit Crunch

While Europe's economic slowdown has led to a decline in corporate borrowing, that trend has been outpaced by the rapid tightening of financial and lending conditions during 2022. Risk-averse banks are increasingly reluctant to participate in the market, especially at the longer tenors at which many corporates now wish to borrow.

We anticipate growth in this demand, as short-dated debt nears maturity, including from high-quality investment grade borrowers, and we believe it represents an attractive opportunity for private lending.

In 2022, central banks around the world rushed to catch up with rising inflation by hiking rates. The European Central Bank (ECB) was no different, raising policy rates and fading out its Targeted Longer-Term Refinancing Operations (TLTRO). The result has been a rapid drop in the money supply (figure 1).

FIGURE 1. EUROZONE MONEY SUPPLY

Year-over-year growth rate

Source: ECB. Data as of December 29, 2022.

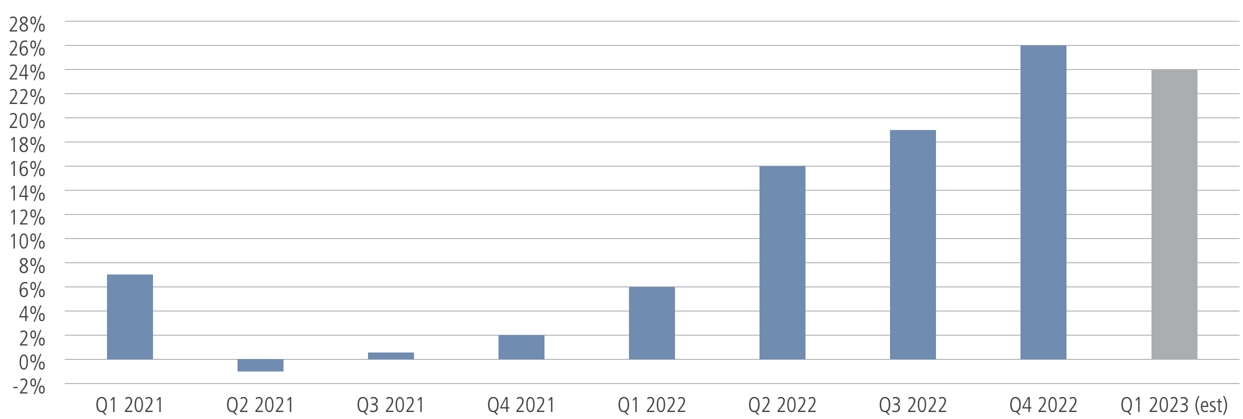
The ECB's survey of bank lending in the eurozone reveals that they, too, are tightening conditions significantly, relative to their stance over much of the past decade.

The 150 banks surveyed in December and January offered their view of how conditions had changed in the fourth quarter of 2022, and 26% reported a tightening of their credit standards, up from 19% in the third quarter, with none reporting easier standards (figure 2). That is the highest level since the Euro Crisis in 2011.

The two main reasons for the tightening were lenders' contractual terms and conditions, and wider margins. Underlying these moves are actual and perceived increases in risks related to the economic outlook, industry- or firm-specific conditions and banks' own declining risk tolerance. The survey suggests that bank lenders expect a similar level of tightening in the first quarter of 2023.

FIGURE 2. HEIGHTENED RISK IS LEADING TO TIGHTER LENDING CONDITIONS

Net percentage of banks reporting a tightening of credit standards, versus those reporting an easing of credit standards



Source: ECB, Bank Lending Survey. Data as of January 31, 2023.

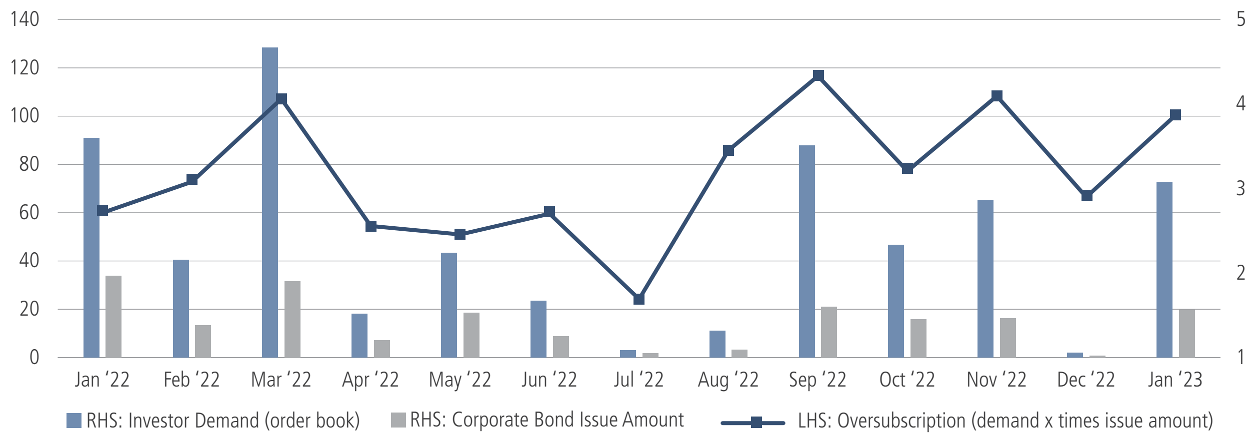
Corporate borrowing has declined as rates have gone up, corporate inventories have filled, fixed investment has slowed and working capital needs have come down. The ECB expects a further decline in borrowing, based on leading sentiment indicators such as Purchasing Managers' Indices (PMIs). However, this trend has been outpaced by the credit tightening by banks shown in figure 2.

In the meantime, because quantitative easing and bank regulation lowered rates in the two- to four-year part of the curve, in particular, and incentivized corporates to borrow at these short tenors, there is a rapidly growing need to refinance. Given the current shape of the yield curve, much of that refinancing appetite is now focused on longer tenors that are not always covered by bank lenders—especially when they are becoming more averse to risk.

We can see this in the substantial drop in new investment grade corporate bond issuance, and subsequent investor oversubscription, through 2022. A total of €191bn was issued, with a 50% drop in new issuance in the second half of the year, leading to demand outstripping supply by 3.3 times, on average (figure 3).

FIGURE 3. DEMAND HAS BEEN OUTSTRIPPING SUPPLY IN INVESTMENT GRADE BONDS

Euro investment grade bond demand and supply (€bn) and oversubscription (multiple of demand over issuance), January 2022 to January 2023



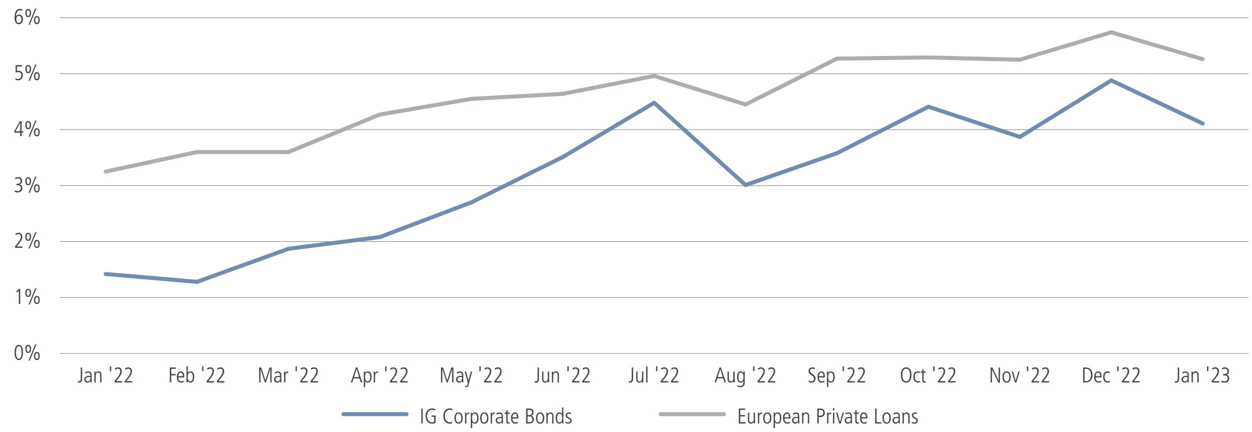
Source: Rabobank.

These supply-and-demand imbalances are giving private markets a serious boost.

Corporate borrowers may need to pay a little more in the private lending market than in the public market (figure 4), but they are far more likely to be able to execute sizable deals at tenors beyond five years, with the option of returning to the public markets if and when rates come back down and lending conditions loosen again. We might therefore describe this as a convenience spread.

FIGURE 4. BORROWERS PAY A CONVENIENCE SPREAD FOR PRIVATE LENDING

Yields on newly issued euro investment grade corporate bonds and private loans, with maturities between five years and 12 years



Source: Rabobank, FactSet, Neuberger Berman. The investment grade corporate bonds universe is compiled from new issuances reported bi-weekly by Rabobank; maturities short than five years and longer than 12 years are excluded as there is no comparable universe of private loan new issues at these maturities. The European private loans universe is a model portfolio of 20 private loans, both completed loans and loans in bank pipelines, designed to be representative of the profile of the private loan market as a whole.

As a result, we are beginning to see even deep investment grade corporates returning to the private markets after a long absence, and risk premia repricing as high-quality borrowers show a willingness to pay more for duration where banks can't deliver.

As figure 3 suggests, there is substantial demand for investment grade exposure among investors. We expect that to increase as investors continue to re-allocate away from higher-risk, lower-rated borrowers, or seek a liquidity premium in new investments to close the gap between current market yields and the low yields of the legacy fixed income assets in their portfolios.

The current dynamics in European lending markets appear ideally suited to meet this demand. The return of high-quality borrowers seeking long tenors could enable investors to recalibrate toward higher-rated loans with more downside protection, while still locking in the highest yields since 2008. A portfolio of BBB euro private loans can now be constructed with a yield around 6%, in our view. That's up more than 300 basis points in less than a year, and it offers more than 175 basis points of liquidity premium over an equivalent public markets exposure.

We think there is likely more interest-rate and credit-spread volatility to come as Europe continues to face headwinds from inflation, a slowing economy and geopolitical tail risks. This macroeconomic uncertainty is, after all, another reason why borrowers are looking for longer-term financing options—and are prepared to pay extra for it. We have already seen pressure on businesses that are cyclical or have energy as a large part of their input costs. Sector selection is likely to be important this year, in our view, with energy and utilities potentially better positioned than capital goods, retail, leisure or consumer products, for example. In general, however, we consider the European credit market to be strongly supportive of private loans.

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